



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	<b>05/07/03</b>	Bill No:	<b>SB 689</b>
Tax:	<b>Cigarette and Tobacco Products</b>	Author:	<b>Ortiz</b>
Board Position:		Related Bills:	<b>SB 921 (Kuehl)</b>

### BILL SUMMARY

This bill would impose an additional excise tax on cigarettes of 0.05 mills (\$0.0005) per cigarette, or \$0.01 per package of 20, and impose an equivalent compensating floor stock tax, operative January 1, 2004. The revenue from the tax increase would be deposited into the Healthy Californians Biomonitoring Fund, which would be administered by the Department of Health Services to implement the Healthy Californians Biomonitoring Project.

### Summary of Amendments

The amendments to this bill that impact the Board make non-substantive technical corrections.

### ANALYSIS

#### Current Law

Pursuant to Revenue and Taxation Code Section 30101 (Cigarette and Tobacco Products Tax Law), an excise tax of 6 mills (or 12 cents per package of 20) is imposed on each cigarette distributed. In addition, Sections 30123 and 30131.2 impose a surtax of 12 1/2 mills (25 cents per package of 20) and 25 mills (50 cents per package of 20), respectively, on each cigarette distributed. The current total tax on cigarettes is 43 1/2 mills per cigarette (87 cents per package of 20).

Sections 30123 and 30131.2 also impose a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. Currently, the surcharge rate for fiscal year 2002-03 is 48.89 percent.

Of the 87 cent excise tax imposed on a package of 20 cigarettes, 2 cents is deposited into the Breast Cancer Fund, 10 cents into the General Fund, 25 cents into the Cigarette and Tobacco Products Surtax Fund, and 50 cents into the California Children and Families First Trust Fund (CCFF Trust Fund). The tobacco products surtax imposed under Section 30123 is deposited into the Cigarette and Tobacco Products Surtax Fund, while the surtax imposed under Section 30131.2 is deposited into the CCFF Trust Fund.

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### **Proposed Law**

Among other things, this bill would add Article 4 (commencing with Section 30133) to Chapter 2 of Part 13 of Division 2 of the Revenue and Taxation Code to impose an additional tax of \$0.01 per package of 20 cigarettes. The tax would be imposed beginning January 1, 2004. The bill would also impose a compensating floor stock tax on the January 1, 2004 cigarette inventory of a dealer, wholesaler and distributor.

The proceeds from the tax increase would be deposited by the Board into the Healthy Californians Biomonitoring Fund, which this bill would create. The fund would be administered by the Department of Health Services to implement the Healthy Californians Biomonitoring Project. The Healthy Californians Biomonitoring Project would utilize blood, urine, breast milk, and other biospecimens, as appropriate, to identify the chemicals that are present in the bodies of Californians, to investigate relationships between specific environmental toxicants and geographic areas, and, in concert with other concerned parties, initiate plans to minimize or eliminate exposure to these contaminants.

### **Background**

Proposition 99, passed on the November 1988 ballot, effective January 1, 1989, imposed a surtax of 25 cents per package of 20 cigarettes, and also created an equivalent tax on tobacco products. Proceeds from the taxes fund health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of 2 cents per package of 20 cigarettes for breast cancer research and early detection services.

Proposition 10, passed November 3, 1998, effective January 1, 1999, imposed an additional surtax of 50 cents per package of 20 cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. The revenues from the additional taxes are deposited into the CCFF Trust Fund and are used to: (1) fund early childhood development programs, and (2) offset any revenue losses to certain Proposition 99 Programs as a result of the additional tax imposed by Proposition 10.

During the 2001-02 Legislative Session, several measures were introduced proposing an increase in the cigarette tax. Those bills include:

- AB 428 (Committee on Budget) would have imposed an additional excise tax on cigarettes of two and one-half cents (\$0.025) per cigarette, or 50 cents per package of 20, and would have imposed an equivalent compensating floor stock tax. Those provisions were amended out of the August 21, 2002 version of the bill.
- AB 433 (Committee on Budget) would have imposed an additional excise tax on cigarettes of thirty-one and one-half mills (\$0.0315) per cigarette, or 63 cents per package of 20, and would have imposed an equivalent compensating floor stock tax. That measure died in the Assembly while waiting for concurrence in the Senate amendments.

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- SB 1849 (Committee on Budget and Fiscal Review) would have imposed an additional excise tax on cigarettes of one hundred six and one-half mills (\$0.1065) per cigarette, or \$2.13 per package of 20, and would have imposed an equivalent compensating floor stock tax. Those provisions were amended out of the August 31, 2002 version of the bill.
- SB 1890 (Ortiz) would have imposed an additional excise tax on cigarettes of 32.5 mills per cigarette, or 65 cents per package of 20, imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax, and imposed an equivalent compensating floor stock tax. That measure died in the Senate Revenue and Taxation Committee.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by The Breast Cancer Fund and Commonweal and is intended to provide a better understanding of the relationship between environmental toxins and the increasing incidence of disease. A better understanding of this relationship could potentially save the state substantial dollars each year in health care costs spent treating disease.
2. **Key amendments.** The May 7, 2003, amendments make non-substantive technical corrections to the provisions of the bill that impact the Board. Specifically, the amendments replace "mils" with "mills" in proposed Section 30133(a), and replace "5 tenths of a cent" with "0.5 mill" in proposed Section 30135(a).

The April 22, 2003, amendments to the bill that impact the Board impose an additional excise tax on cigarettes of \$0.01 per package of 20, and impose an equivalent compensating floor stock tax, operative January 1, 2004, to fund the implementation of the Healthy Californians Biomonitoring Project.

3. **This measure does not contain a separately stated additional tax increase on tobacco products.** However, the \$0.01 cigarette tax increase would increase the tobacco products tax rate July 1, 2004 as a result of Proposition 99. Section 30123(b) (Proposition 99) generally provides that the tobacco products tax rate, which is required to be determined annually by the Board, must be equivalent to the combined rate of tax imposed on cigarettes. As such, a tax increase on tobacco products is automatically triggered whenever the tax imposed on cigarettes is increased.

However, an increase to the tobacco products tax rate as a result of this bill would not be effective until the 2004-05 fiscal year because current law provides that the Board determine a tobacco products rate "annually." The Board is scheduled to determine the rate for the 2003-04 fiscal year on May 28, 2003 and that rate will be in effect July 1, 2003. A new tobacco products tax rate will not be determined until 2004, which would be effective for the 2004-05 fiscal year.

It should be noted that the proceeds from the resulting tobacco products tax increase would not be deposited into the Healthy Californians Biomonitoring Fund. The proceeds would be deposited into the Cigarette and Tobacco Products Surtax Fund (created by Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

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4. **This bill could increase the incentive to evade the cigarette tax.** Tax evasion is one of the major areas that can reduce state revenues from cigarettes and tobacco products. Board staff recently estimated that cigarette tax evasion in California was running at a rate of approximately \$292 million annually. That estimate was only for evasion of cigarette taxes, and did not include associated evasion of other taxes, such as sales and use, tobacco products or income taxes.

A key premise in the Board's research is that both cigarette consumption and cigarette tax evasion are highly correlated to product prices and excise tax rates. For example, two major events that occurred since November 1998 dramatically increased California excise taxes as well as cigarette prices excluding taxes: Proposition 10 and the Tobacco Master Settlement Agreement made between states and tobacco manufacturers (tobacco settlement). Together, these two developments, when coupled with typical wholesaler and retailer distribution margins, have increased average prices of cigarettes to California consumers by about 50 percent in relation to early November 1998 prices. It was estimated that the impacts of Proposition 10 and the tobacco settlement more than doubled cigarette tax evasion in California.

5. **This measure could increase state and local sales and use tax revenues.** Under current Sales and Use Tax Law, the total amount of the retail sale is subject to sales or use tax unless specifically exempted or excluded by law. Because the excise tax on cigarettes is not specifically exempted or excluded, it is included in the total amount of the sale and subject to sales or use tax.

This measure would increase the excise tax on cigarettes, which may be passed on to the ultimate consumer through an increase in the retail-selling price of cigarettes. Any increase in the amount of the retail-selling price of cigarettes as a result of this measure would be included in the amount on which sales or use tax is computed. The impact on state and local sales and use tax revenues is discussed in the Revenue Estimate.

6. **This bill contains floor stock tax provisions.** Proposed Section 30135 contains language to impose a floor stock tax on a dealer's, wholesaler's and distributor's inventory. A floor stock tax is important because it equalizes the excise tax paid by cigarette dealers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase. Having a large cigarette inventory before a tax rate increase takes effect can result in a windfall profit to a cigarette seller. The selling price of cigarettes can be raised and attributed to the rate increase, but the additional funds collected are profit and not an excise tax paid to the state. A floor stock tax mitigates this windfall.

As an example of the impact of not having a floor stock tax, in apparent anticipation of the tax increase of 2 cents per package of 20 cigarettes for funding breast cancer research projects beginning in January 1, 1994, sales of cigarette stamps jumped by \$34.8 million in December 1993, or enough stamps for 99 million packs of cigarettes. There was a corresponding decrease in the number of stamps purchased in January and February 1994. Because distributors had an adequate inventory of 35-cent cigarette stamps on hand to affix to their cigarette packages, they could delay for months having to buy the 37-cent stamps which were sold beginning January 1,

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1994. This huge inventory stockpiling translated into \$2 million in lost revenue for the Breast Cancer Fund, money which had been anticipated as part of the original revenue estimate.

While there are additional costs associated with administering the floor stock tax, the revenue substantially compensates for that cost.

7. **This bill would increase the distributor's discount.** Section 30166 provides that stamps and meter impression settings shall be sold at their denominated values less 0.85 percent to licensed distributors. As such, distributors currently receive a discount of \$4.44 per case of cigarettes<sup>1</sup> (600 stamps x \$0.87 tax per package of cigarettes x 0.85 percent discount = \$4.44 discount). By increasing the excise tax on a package of 20 cigarettes to \$0.88, this bill would increase the distributor's discount to \$4.49 per case (600 stamps x \$0.88 tax per package of cigarettes x 0.85 percent discount = \$4.49 discount).

It should be noted that AB 71 (Horton) would eliminate the 0.85 percent distributor's discount and would instead provide distributors a discount at amount equivalent to 0.39 mills (\$0.00039) per cigarette (or \$0.0078 per package of 20 cigarettes). The flat rate discount would become operative only if a cigarette surtax is enacted, as specified.

8. **Suggested technical amendment.** On page 18, lines 18 through 20, the language is unnecessary. The language provides that the tax imposed shall be imposed on cigarettes in the possession or under the control of every dealer and distributor on and after 12:01 a.m. on January 1, 2004. Since this language duplicates the language contained in Section 30135, it is suggested that Section 30133(b) be stricken from the bill.
9. **Related Legislation.** Senate Bill 921 (Kuehl) contains intent language to dedicate revenue from, in part, an unspecified cigarette and tobacco products surtax to fund a newly established California Health Care System.

### COST ESTIMATE

A detailed cost estimate is pending. However, the Board would incur costs related to this measure for notifying potential feepayers, developing returns, computer programming, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering a floor stock tax.

### REVENUE ESTIMATE

Tax-paid cigarette distributions were 1,237 million packs in fiscal year 2001-02, down about 4 percent from 2000-01. According to the 2003-04 *Governor's Budget Summary*, total cigarette consumption is estimated to decline in the range of 3.5 percent annually in the next few years. If so, consumption is estimated to be 1,152 million packs in fiscal year 2003-04, (1,237 million packs x 0.965 x 0.965 = 1,152 million packs).

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<sup>1</sup> There are 600 packs of cigarettes per case.

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**Fiscal Year 2003-04 Cigarette Revenues.** The new rate becomes effective January 1, 2004, which implies a half-year impact for fiscal year 2003-04. Consumption for the period January 1, 2004 through June 30, 2004 is estimated to be 576 million packs  $((6/12) \times 1,152 = 576)$ .

The current tax rate on cigarettes is \$0.87 per pack. Under the proposal, this rate would apply from July through December 2003. An estimated 576 million packs would be taxed at the current tax rate of \$0.87 per pack in fiscal year 2003-04  $((6/12) \times 1152 = 576)$ . A \$0.01 per pack increase (total excise tax of \$0.88 per pack), starting January 1, 2004 would result in increased excise tax revenues for fiscal year 2003-04 as follows:

	Packs (millions)	Rate (per pack)	Revenue (millions)
Current Rate	576	\$0.87	\$ 501.1
Proposed Rate	576	\$0.88	\$ 506.9
Difference			<u>\$ 5.8</u>

A corresponding floor stock tax, assuming a three weeks supply of cigarettes  $(3 / 52) \times 1,152 = 66.5$ , would produce \$0.7 million in additional revenue  $(66.5 \text{ million packs} \times \$0.01 = \$0.7 \text{ million})$ .

**Fiscal Year 2004-05 Revenues.** For revenues under current law, we assumed another 3.5 percent decline in tax-paid cigarette distributions, to 1,112 million packs  $(1,152 \times 0.965 = 1,112)$ .

	Packs (millions)	Rate (per pack)	Revenue (millions)
Current Rate	1,112	\$0.87	\$967.4
Proposed Rate	1,112	\$0.88	<u>\$978.6</u>
Difference			<u>\$ 11.2</u>

**Tobacco Products Tax.** Following the precedent of Proposition 10 tax increase, the Proposition 99 tax rate would automatically increase by the equivalent of \$0.01 per pack on July 1, 2004.

The effective tobacco products tax is currently based on the wholesale cost of these products at a tax rate that is equivalent to the rate of tax imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. For rate setting purposes, the average cost per cigarette for the 2002-03 fiscal year is \$0.1401. The current tax rate on cigarettes is \$1.37 per pack, or \$0.0685 per cigarette<sup>2</sup>. The tobacco products tax rate for 2002-03 is 48.89 percent  $(\$0.0685 / \$0.1401 = 0.48894)$ . We will assume this rate stays constant for the next two fiscal years. (A new rate for the upcoming fiscal year is typically set in late May, so we do not yet have data for the proposed 2003-04 rate.)

<sup>2</sup> The current effective rate of \$1.37 per pack for tobacco products consists of \$0.87 per pack related to Proposition 99 and \$0.50 per pack related to Proposition 10.

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The Proposition 99 tax rate would increase the 2004-05 tobacco products tax rate by 0.36 percent on July 1, 2004 ( $0.01 / 20 = 0.0005$ ;  $0.0005 / 0.1401 = 0.0036$ ) in the Board's rate setting calculations. The wholesale cost of tobacco products was \$77.1 million during the 2001-02 fiscal year.<sup>3</sup> The revenue increase under SB 689 would be approximately \$0.3 million ( $77.1 \times .0036 = 0.3$ ).

### Revenue Summary

In fiscal year 2003-04, cigarette tax revenues would increase by \$6.5 million. (This figure is comprised of a half-year impact of \$5.8 million, plus floor stock tax revenues of \$0.7 million.) In fiscal year 2004-05 (the first complete fiscal year the SB 689 tax rate would be in effect), cigarette and tobacco products tax revenues would increase by \$11.5 million. (This figure is comprised of a cigarette tax impact of \$11.2 million, plus tobacco products tax revenues of \$0.3 million.)

### Sales and Use Tax Impacts

State and local sales and use tax revenues associated with a \$0.01 per pack cigarette tax increase (and the linked tobacco products tax increase) would be \$0.5 million for fiscal year 2003-04 and \$0.9 million for fiscal year 2004-05. These are broken out as follows:

	<u>Increased Revenue</u>	
	<u>2003-04</u>	<u>2004-05</u>
State (5%)	\$0.3	\$0.6
Local (2.25%)	\$0.1	\$0.2
<u>Transit (0.67%)</u>	<u>\$0.1</u>	<u>\$0.1</u>
Total	<u>\$0.5 million</u>	<u>\$0.9 million</u>

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<sup>3</sup> Source: BOE Excise Taxes Division. Cited in a memo from Dave Hayes to Board Members, October 22, 2001, "Effects of Proposition 10 on Cigarette and Tobacco Products Consumption."

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